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## THE RESERVE ASSOCIATION AND THE IMPROVEMENT OF METHODS OF MAKING PAYMENTS BETWEEN THE BANKS<sup>1</sup>

The serious defects in our credit machinery, disclosed in successive crises, have created the impression that to escape panics in the future it is necessary to provide and to hold in reserve somewhere in our banking system the means for a prodigious increase in the supply of credit and currency. In the discussion of the proposed Reserve Association, evidence of this view is found in the almost exclusive attention which has been given to its rediscounting operations and to the conditions under which it may issue notes. These are important matters; indeed they are essential means of enabling the other banks to meet unusual demands that may be made upon them. I wish to call attention in this paper, however, to another activity of the Reserve Association—one which may prove equally important as an emergency safeguard, and which may constitute, perhaps, its principal function during the long years of normal business activity, when its duties will be of an ordinary routine character.

It is generally agreed that our banks do not need a large and continuous supply of accommodation from the Reserve Association. In most parts of the country, existing banking resources are adequate for average local needs. In a few newly settled and rapidly developing localities, this is perhaps not the case, though even in such instances the real need is far more for additional permanent capital than for that temporary accommodation to provide which is the primary function of the commercial bank. It is occasional requirements, such as those in connection with crop movements, and unexpected needs of an emergency character, that our banks have experienced difficulties in satisfying. The difficulty at such times may be due to a positive increase in the demand for loans. In such instances the advantage of being able to secure rediscounts

<sup>1</sup> A paper read before the Western Economic Society, November 11, 1911.

from the Reserve Association is evident. But more frequently the difficulty arises, not from any increase in the demand for loans, but as a consequence of withdrawals of cash, which cause the banks to reduce the total volume of accommodation to borrowers. Here again rediscounts would enable the banks to maintain the customary ratio of reserve to demand liabilities without resorting to contraction. But if money requirements for use either outside the banks or between the banks can be lessened and made more regular, the necessity of resorting to the Reserve Association for accommodation will also be diminished. Precisely this result will be gained through the facilities which the Reserve Association will afford for making settlements not only between the banks in places where its branches are established, but also between the banks of the different sections of the country. The importance of this indirect means of strengthening our banking system evidently depends upon the extent to which money will in fact be economized and its use made more regular. An analysis of the various ways in which the Reserve Association can accomplish this result is the subject of the present paper.

The mere presence of the Reserve Association, assuming it to have the confidence of the business community and the banks, will do much. In every period of financial stress in our history it is probable that even in the large cities, where the strain has been most severe, the banks could have handled the situation successfully if the disturbance had remained purely local. But in every instance, the reserves, and consequently the lending power, of the city banks have been weakened by the withdrawal of funds lent or deposited in the cities by outside banks. In a measure these withdrawals were entirely reasonable and natural, a proper means of strengthening themselves on the part of the country banks. However, much more cash than was required for such needs has always been withdrawn, owing in part to unreasoning fear of their own depositors, but chiefly to distrust of the ability of the city banks to maintain payments. It would seem certain that the enormous extent of such withdrawals in the past, or, to speak more accurately, attempted withdrawals, is no measure of what they will be in a future emergency after our banking system has been

strengthened by the establishment of the Reserve Association. While emergency requirements for cash will not be entirely done away with, we may confidently expect that they will be confined within far more reasonable limits.

Moreover, these "reasonable limits" will be something quite different from what they have been in the past. At present many banks are separated by enormous distances from their reserve agents. When banks thus situated experience unusual demands for cash from depositors, they naturally and properly call for larger shipments of currency than there is any great likelihood that they will be obliged to use. The branches of the Reserve Association will place very nearly every banker within easy reach of the deposited portion of his reserve. This will be true, not only of balances carried with the Reserve Association, but also of those held by reserve agents in any of the cities in which it has branches; by means of telegraphic transfers such balances can be made immediately available at the nearest branch of the Reserve Association. It may, therefore, be reasonably presumed that country banks generally will only draw upon their balances, day by day, as the need for cash presents itself.

Greater confidence of the banks in each other, as well as confidence in the Reserve Association, is requisite to secure in full measure the results which have been so far dwelt upon. Fortunately the establishment of the Reserve Association may be expected to have just this effect. The knowledge that any bank can resort to it for accommodation will do much to strengthen the confidence of the banks in each other. This strengthening of confidence will also be one of the most valuable results of the various improvements which the Reserve Association may make in the settlement of payments between the banks. With the analysis of these improvements the remainder of this paper will be concerned.

In all countries in which reserves have been centralized, clearing-house balances are settled by transfers on the books of the central institution. It may be presumed that similar arrangements will be made by the banks in all the cities in which a branch of the Reserve Association is established. The economies in the use of money which will follow are evident. If, for example, each Chicago

bank made daily settlements with all the other banks of the city singly, a very considerable portion of the reserve of the banks would be in constant use. Through the clearing-house the amount of money required for this purpose is reduced to a remarkable extent. Similarly, where clearing-house balances are settled by transfers on the books of a single institution, a further economy is secured; indeed the use of money in dealings between the banks is entirely eliminated. In the absence of such arrangements, a bank borrowing from the Reserve Association on account of the depletion of its reserves from a succession of unfavorable clearing-house balances would be obliged to take the proceeds of its loan either in specie or in bank notes. As the power of the Reserve Association to issue notes is to be limited, it will be clearly to the advantage of the banks to adopt arrangements which will tend to make its less restricted form of credit, the deposit, serviceable in every possible way.

Even though the clearing-house balances continue to be settled with money, the establishment of the Reserve Association will have one important consequence of particular moment, in connection with clearing-house activities. As it will stand ready to make advances to the various banks, the issue of clearing-house loan certificates in emergencies will become unnecessary. This device, absolutely indispensable under our present system in order to avoid wholesale loan contraction, has proved inadequate as a means of securing the effective use of the reserves of the banks ever since the complementary device for the equalization of cash holdings was dropped after the crisis of 1873. Banks the reserves of which were ample have taken out certificates, thus making it impossible for other banks to secure needed funds from favorable clearing-house balances. It is conceivable that in future emergencies banks may seek to strengthen themselves by means of rediscounts at the Reserve Association, even though their reserves have not been seriously depleted. The Reserve Association, however, will be in position to see that its resources are applied where they are clearly needed. The mere intimation that a certain measure of discrimination might be shown in the granting of rediscounts would be quite enough. Instead of relieving the other banks of their respon-

sibilities, the Reserve Association will be in position to exert a powerful influence toward securing the regular performance of their duties by the banks, including the use of their own cash resources.

Much more than improvements in the methods of making settlements between the banks in the cities in which it has branches can be accomplished by the Reserve Association. The most seriously disturbing feature in all our crises has been the discontinuance of payments between different sections of the country, and the consequent dislocation of the domestic exchanges. Bankers everywhere have found themselves burdened with increasing accumulations of checks which were for the time being an unavailable cash asset. Depositors have consequently been unable to make or to secure payment in the ordinary way, and the movement of commodities has been seriously interrupted. When the machinery for making payments between different places is in normal working order, relatively small payments of money are required, checks and drafts largely offsetting each other. For the maintenance of the domestic exchanges in working order in emergencies some changes are needed to prevent the collapse of its mechanism, not a quantity of currency sufficient to take the place of existing instruments for payment, the check and the draft. The domestic exchanges have broken down repeatedly, but there has always been one part of the mechanism, the defective working of which has caused the disaster. When city banks discontinue or restrict shipments of currency to their banking correspondents, the entire machinery of the domestic exchanges must inevitably break down, because it is through the city banks that settlements are made between all the banks of the country. If we can make certain the continuance of payments by the city banks, checks and drafts will continue to be used in the ordinary way, and at the most in emergencies nothing more serious will happen than spasmodic instances of delay in remittance by a sprinkling of the country banks.

The possibility of securing rediscounts from the Reserve Association will do much to remove the temptation or necessity of resorting to the restriction of payments by the city banks, to say nothing of the further possibility that the Reserve Association

might discriminate against banks which fail to do their utmost to stem the tide of panic. Further the city banks will probably find it impossible to restrict payments, even if they so desire, since drafts on reserve agents could be sent to the Reserve Association for collection, payment being made from the balances of the city banks with the central institution. The exhaustion of such balances, while a bank had cash in its own vaults, would be unlikely, because the maintenance of balances is to be required of all banks enjoying the rediscount privilege.

Up to this point in the analysis of the influences which the Reserve Association may exert over the domestic exchanges, the extreme case has been assumed that the banks in some future emergency may work at cross-purposes more consciously and more unreasonably than in past crises. This unlikely supposition has received attention because it brings out very clearly the remedy which the Reserve Association may apply even in such unfavorable circumstances. In this analysis, moreover, the Reserve Association has been considered as if in ordinary times it would have nothing to do directly with the domestic exchanges. In practice it is certain to become the most important part of the machinery for making settlements between different parts of the country, not merely in emergencies, but in the regular course of its operations.

It is becoming more and more generally recognized among bankers that existing arrangements for handling checks drawn on distant banks are most unsatisfactory. Collections place on the banks a heavy burden of expense which cannot be entirely shifted upon their customers. No system of handling checks will be entirely satisfactory which does not secure the following results—prompt remittance at par on all checks by country banks to the nearest city or cities which are clearing-centers for the locality, the disappearance of domestic exchange charges between cities in different sections of the country, and the disappearance of all charges upon currency shipments. Very likely these results will seem impossible to those familiar with present conditions. Can it be possible that the Reserve Association will possess such wonder-working powers? Reversing the order of the ends to be accom-

plished, let us see how far its influence may be extended in this direction.

In the first place, the Reserve Association must ship currency without charge to any depositing bank. Section 72 of the proposed plan is as follows: "The National Reserve Association and its branches shall at once upon request and without charge for transportation forward its circulating notes to any depositing bank against its credit balance." Free shipments of currency will not be limited to the balance of a bank with the Reserve Association, since another section of the act (Section 47) contains the following provision: "It shall be the duty of the National Reserve Association or any of its branches upon request to transfer any part of the deposit balance of any bank having an account with it to the credit of any other bank having an account with the National Reserve Association." It will thus be seen that balances with reserve agents situated in the same city in which the country bank has a balance with the Reserve Association can be readily transferred and without cost. But suppose the balance is with a reserve agent situated in some other city. The preliminary transfer to the Reserve Association might then involve some expense to the country bank, since, to quote a further clause in Section 47 of the measure: "If the deposit balance is transferred from the books of one branch to the books of another branch, it may be done under regulations to be prescribed by the National Reserve Association, by mail or telegraph at rates to be fixed at the time by the executive committee of the branch at which the transaction originates." It is, however, most unlikely that the Reserve Association will impose any charge for this service. The expense of currency shipments to it will be insignificant, compared with that under our present system. On the familiar clearing-house principle, payments between the different parts of the country will largely offset each other if settlements are handled through a single institution. Moreover, the Reserve Association would not be obliged to be continually shipping currency back and forth between its various branches. However limited its power to issue notes may be, it can keep on hand at its various branches an indefinitely large stock of them. Further, while the Reserve Association might be able to

charge something for making transfers for the banks, it will certainly find no advantage in doing so. Unable to offer interest for deposits, one of its most potent means for attracting them will be this service of transferring funds between its branches free from all charges.

We have thus eliminated two of the three elements of expense in connection with the collection of checks—shipments of currency to the country banks from the reserve city having a branch of the Reserve Association, and remittances between the various cities in which the association may establish branches. Let us take a rather extreme case for illustration: a check drawn upon a country bank in the interior of Oregon and deposited in an Illinois country bank. It will cost the Illinois bank nothing to get the proceeds of the check from its Chicago reserve agent, and it will also cost the reserve agent nothing to secure the transfer of the proceeds of the check from its correspondent in that part of the country, presumably in Portland. There remains the remittance to the Portland correspondent by the Oregon bank, on which the check was drawn. Is there any reason to suppose that after the establishment of the Reserve Association the Oregon banks will discontinue charging for exchange and for the vexatious delay of remittances if they have indulged in such practices in the past? There is an interesting provision in the proposed plan for the Reserve Association which seems to look toward the development of better arrangements for handling this end of the check collection business. I refer to Section 31, which reads as follows: "Any local association may by a vote of three-fourths of its members and with the approval of the National Reserve Association assume and exercise such powers and functions of a clearing-house as are not inconsistent with the purposes of this act. The National Reserve Association may require any local association to perform such service in facilitating the domestic exchanges of the Reserve Association as the public interests may require." Under this provision, each local association may devise arrangements for handling the checks drawn on its members similar in general to those in use in the cities, making settlements, presumably, by means of telegraphic transfers on the books of the nearest branch of the Reserve Asso-

ciation. More complicated arrangements would have to be devised for handling checks drawn on a bank in one local association and deposited in a bank belonging to another local association; and in particular for those deposited outside one of the various districts in number equal to the number of the branches of the Reserve Association into which the local associations are to be grouped. The simplest method would doubtless be that of gathering together all checks deposited in banks in one association and drawn on banks in another association, and handling them through the Reserve Association and its branches; but probably the banks will continue to prefer to send checks for collection to reserve agents as at present. As regards the securing of remittances from the banks on which checks are drawn, a change in existing methods would seem not unlikely. City banks would be relieved of an onerous burden, if they could transfer checks for collection through the nearest branch of the Reserve Association to the local associations. The Reserve Association itself would be able to exert such pressure as might be needed to secure prompt remittance at par. The collection of checks would still involve considerable clerical expenditure, though far less than at present, and the loss of time for transmission; but this also would be materially shortened. While it might not be possible for the banks to accept all checks without imposing some collection charge, the area within which it would become possible for any given bank to do so would be greatly extended.

Other advantages of a more general nature would also follow from the adoption of some such unified method of handling checks as has just been described. It is inconceivable that under a system of this sort, completely organized, any future emergency could lead to the dislocation of the domestic exchanges. With all settlements between banks made on the books of the Reserve Association no bank, so long as it retained the confidence of its depositors, would experience a loss of actual cash, except when there was a positive need for additional money for actual use outside the banks for making payments which cannot conveniently be made with checks. Such requirements are not subject to wide variation; even the movement of the crops requires far less cash than is generally supposed. A large part of the money withdrawn by the

country banks is not actually paid out by them. Uncertainty as to the extent of such requirements causes much more to be taken by them than is actually used.

As a result of the economy of cash and the greater regularity in its use which may be anticipated from the facilities provided by the Reserve Association, it will probably be found that its power to issue notes will be exercised far less than its power to extend credit in the form of deposits. In this respect the business of the Reserve Association may be expected to approach more and more that of the Bank of England. It will be a bank subject to heavy withdrawals of cash, at times, on account of foreign payments, but to comparatively slight fluctuations in the volume of its note issue, changes in which will be due to changes in domestic requirements for cash outside the banks. On the other hand, variations in its deposit liabilities will probably be subject to wide fluctuations, reflecting the varying requirements of the banks.

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